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BEFORE THE
POSTAL REGULATORY COMMISSION

Statutory Review of the System for Regulating Rates and Classes for Market-dominant Products	: : :	**Docket No. RM2017-3**

COMMENTS OF UNITED PARCEL SERVICE, INC. ON ADVANCE NOTICE OF PROPOSED RULEMAKING ON THE STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET-DOMINANT PRODUCTS (March 20, 2017)

United Parcel Service, Inc. ("UPS") respectfully submits these comments in response to the Commission's Advance Notice of Proposed Rulemaking in this docket concerning the statutory review of the market-dominant rate system established under the Postal Accountability and Enhancement Act ("PAEA").[1] As UPS has argued in several dockets, the United States Postal Service ("Postal Service") has built its competitive products business on the back of its market-dominant customers and continues to require those captive customers to bear a disproportionate share of the cost of operating its businesses. The market-dominant rate system has contributed to this result in a manner that conflicts with its statutory objectives. *See* 39 U.S.C. § 3622(b).

This ten-year review of the market-dominant rate system provides an important opportunity to consider and address these issues. UPS urges the Commission to bear in mind one of Congress' intentions in enacting PAEA a decade ago: preventing the

[1] Advance Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market-dominant Products, Dkt. No. RM2017-3 (Dec. 20, 2016); 39 U.S.C. § 3622(d)(3).

Postal Service from subsidizing its competitive business with revenue extracted from market-dominant mailers. 39 U.S.C. 3633(a)(1). UPS urges the Commission to retain the market-dominant rate cap as a safeguard against such abuse. If the Commission, however, decides to relax the rate cap in any way, UPS respectfully requests that the Commission institute counterbalancing safeguards to ensure that any additional revenue gained by rate increases on market-dominant products above and beyond the rate cap are used to benefit the market-dominant business. Any such modifications to the market-dominant rate system should be entered into carefully and incrementally in order to avoid unintended consequences.

As part of this rate review, the Commission is obliged to consider whether the market-dominant rate system "maximize[s] incentives to reduce costs and increase efficiency." 39 U.S.C. § 3622(b)(1). As UPS has previously argued, the Postal Service has unique incentives as a governmental monopolist that create risks that it will tend to prioritize volume and scale over efficiency.[2] In light of these incentives, the rate cap provides an important measure of discipline that requires the Postal Service carefully to focus on its ability to "reduce costs and increase efficiency," 39 U.S.C. 3622(b)(1), rather than simply raising the rates of market-dominant customers. Without the rate cap, the Postal Service's incentives to be efficient would be reduced.

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[2] *See* Petition of United Parcel Service, Inc. For The Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, Dkt. No. RM2016-2 (Oct. 8, 2015), at 2, 4, 19; Reply Report of Dr. Kevin Neels to Accompany UPS Reply Comments, Dkt. No. RM2016-2 (March 25, 2016), at 6-7; Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (January 23, 2017), at 26-27; Declaration of Dennis W. Carlton, Dkt. No. RM2017-1 (March 9, 2017), at 7-10; Reply Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (March 9, 2017), at 5, 9-11.

The Commission must also ensure that the market-dominant rate system is allocating "the total institutional costs of the Postal Service appropriately between market-dominant and competitive products." 39 U.S.C. § 3622(b)(9). This "appropriate" allocation is not occurring today, primarily because the Postal Service is covering the increased institutional costs associated with its focus on competitive products at least in part with revenues from market-dominant products.

The Postal Service has stated that its goal is to transform into "a delivery service for the e-commerce era" in which it will deliver "fewer letters and more packages."[3] In 2014 the Postal Service explained, "'We've been focusing a lot of efforts on package growth, because that's the biggest opportunity for us,'. . . . The Postal Service is aiming to more than double its package-delivery business within a few years."[4] This focus has imposed major costs on the Postal Service, such as a $1.6 billion year-over-year increase in labor and transportation costs that the Postal Service acknowledged was "largely due to the increase in Shipping and Packages volumes, which are more labor-intensive to process and require greater transportation capacity than mail."[5]

But even as the Postal Service continues to make large investments in competitive markets, it is able to shift most of these costs to the market-dominant side of the ledger because of the negligible responsibility competitive products bear for

[3] Devin Leonard, *It's Amazon's World. The USPS Just Delivers in It*, BLOOMBERG BUSINESSWEEK (Jul. 30, 2015), www.bloomberg.com/news/articles/2015-07-30/it-s-amazon-s-world-the-usps-just-delivers-in-it (last visited Mar. 20, 2017).

[4] Laura Stevens, *For FedEx and UPS, a Cheaper Route: the Post Office*, WALL ST. J. (Aug. 4, 2014), www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247 (last visited Mar. 20, 2017).

[5] *U.S. Postal Service Reports Fiscal Year 2016 Results*, UNITED STATES POSTAL SERVICE (Nov. 15, 2016), https://about.usps.com/news/national-releases/2016/pr16_092.htm (last visited Mar. 20, 2017) (emphasis added).

covering the institutional costs of the enterprise.[6] This concern is amplified by the narrow definition of causation used by the Postal Service, under which billions of dollars in variable costs (including those driven at least in part by competitive products) are classified as institutional.[7] Because of these practices, market-dominant customers are ultimately responsible for a disproportionate share of costs.

The Postal Service can readily extract sufficient funds from these customers because of its postal monopoly. By law, the Postal Service has a monopoly over market-dominant products, allowing it to exert substantial pricing power over customers.[8] This pricing power allows the Postal Service to earn returns on market-dominant products that it can use to pay for the growing portion of institutional costs that are being incurred to build and support its competitive operations.[9] Mailers thus end up paying for investments and expenses they do not benefit from, while the Postal Service leverages those investments to undercut efficient private sector rivals in competitive markets.

As a safeguard against the Postal Service's monopoly power, PAEA includes an instruction to set "an annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index for All Urban Consumers unadjusted for seasonal variation over the most

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[6] *See* Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Jan. 23, 2017), at 29.

[7] *See* Proposal One — A Proposal to Attribute All Variable Costs Caused By Competitive Products to Competitive Products Using Existing Distribution Methods, Dkt. No. RM2016-2 (Oct. 8, 2015), at 7-8.

[8] 18 U.S.C. §§ 1693–1696; 39 U.S.C. §§ 601–606.

[9] *See, e.g.,* Public Cost and Revenue Analysis, UNITED STATES POSTAL SERVICE (FY 2015), at 3 (showing cost coverages *above 300%* for certain market-dominant products).

recent available 12-month period preceding the date the Postal Service files notice of its intention to increase rates." *See* 39 USC § 3622(d)(1)(A). By including this "rate cap" provision, PAEA places an upper limit on the amount of costs to be covered by market-dominant mailers, as the revenue obtained from those mailers, and thus the source of funds for Postal Service competitive investments, is limited by the rate cap.[10] In this way, the rate cap complements the minimum appropriate share requirement for competitive products, by putting a limit on the absolute contribution market-dominant products can make, given current market conditions. This effectively limits the extent to which market-dominant mailers are forced to pay institutional costs for which they are not responsible.

The Postal Service has of late been seeking to eliminate this important protection. The Postal Service claims that the rate cap is "fundamentally unsuited to the Postal Service's current business environment" and should be "replaced with a system that provides greater pricing flexibility and better reflects the economic challenges facing the Postal Service."[11]

UPS believes the Commission should reject the Postal Service's attempt to remove this safeguard. Not only does it protect market-dominant customers from monopolist price increases, but it also provides a secondary check on the Postal

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[10] Price cap regulation is recognized as a useful tool in a variety of regulated industries. *See* Mark Lowry and Lawrence Kaufman, "Performance-based Regulation of Utilities," ENERGY LAW JOURNAL, Vo. 23:399, 408 (2002) (discussing price cap regulation of Telecommunications, Railroads, Energy Utilities, and Oil Pipelines); David E.M. Sappington, "Price Regulation," HANDBOOK OF TELECOMMUNICATIONS ECONOMICS 237 (Martin E. Cave et al. eds., Elsevier: Amsterdam 2002) (discussing the widespread nature of price regulation, including a discussion of 40 out of 50 states implementing a price regulation scheme).

[11] United States Postal Service, Forced Price Reduction to Worsen USPS Financial Condition by $2 Billion Per Year (Feb. 25, 2016), https://about.usps.com/news/national-releases/2016/pr16_009.htm (last visited Mar. 20, 2017).

Service's ability to over-invest in competitive markets using revenues collected from market-dominant mailers.

If the rate cap is to be relaxed in any way, UPS respectfully requests that the Commission institute additional safeguards to ensure that market-dominant rate increases are not used to fund the expansion of the competitive products business. One possibility would be to raise and enforce higher service standards for market-dominant products. By doing so, the Commission would ensure that the additional revenues captured from market-dominant products would in turn be used to improve service for those same market-dominant products. Improved performance standards for market-dominant products might also help offset the likely reduction in demand for market dominant products that would otherwise occur. Another possibility would be to set up a meaningful Competitive Products Fund, which would prevent the comingling of market-dominant revenue and competitive revenue. Today, the Competitive Products Fund is essentially toothless because the Postal Service only effectuates transfers once per year to and from the Competitive Products Fund.[12] PAEA demands more rigor — the Postal Service should utilize the Competitive Products Fund and the Postal Service Fund on an ongoing basis as it collects revenue from both categories of products. If implemented in accordance with the PAEA, the Competitive Products Fund could be used to ensure that market-dominant revenue is only used for market-dominant costs, providing another protection against the use of market-dominant revenue to fund competitive expansion.

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[12] *See* Responses of the United States Postal Service to Chairman's Information Request No. 11, Dkt. No. ACR2016 (Feb. 3, 2017), at Q.10.

Respectfully submitted,

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